

# “Tax Cuts and Jobs Act”: 18 Months Later

A Select View of Tax Issues for Commercial Entities

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# Select Seminal Statutes, Regulations And Court Cases After The Passage Of The TCJGA

1. Choice of entity (21% corporate rate vs. “29.6%” passthrough rate).
2. Section 199A (passthrough deduction).
3. Section 1061 (partnership interests held in connection with performance of services aka “carried interest”).
4. State and local sales/use taxes after *Wayfair*.
5. Opportunity zones.
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# Choice of Entity

**21%**

Corporate income tax rate  
now (flat rate).

**37%**

Passthrough income tax rate  
now (maximum individual  
marginal rate).

**But reduced to 29.6% if the new  
Section 199A 20% deduction  
applies.**

# Choice of Entity



**200,000<sup>+</sup>**

**Pass-through entities predicted to convert to C corporation status!**

*Source: Penn Wharton Budget Model 6/12/2018*

# Choice of Entity



**But 200,000 conversions are less than 5% of all passthroughs (1% if sole proprietorships are included).**

*Source: S-corp.org estimates (accessed June 17, 2019)*

# Choice of Entity: *Four Factors*

1

Are you subject to 3.8% Medicare surtax?

2

Is the 20% 199A deduction available?

3

Will you distribute earnings annually?

4

How long will you retain earnings?

James R. Repetti. "The Impact of the 2017 Act's Tax Rate Changes on Choice of Entity." Florida Tax Review 21, No.2 (2018): 686-714.

# Conversions

## Factors to Consider

- Will the company pay dividends?
- Will the company sell in five years?
- AAA for S corporations and post-termination distributions?
- Seeking new investors like venture capital or private equity?
- Dozens (hundreds) more factors.



# Choice of Entity (Cont.'d)

It (*probably*) makes sense to be a C corporation  
*if and only if*  
the company is going to **retain earnings**.

# C corporation has two layers of taxation

**Corporate-level tax** : 21% flat rate.

**Stockholder-level tax**: 20% rate (maximum) <sup>1, 2</sup>

1. Assumes a tax-paying stockholder. *But cf.* Burman, Leonard E. and Clausing, Kimberly A. and Austin, Lydia, Is U.S. Corporate Income Double-Taxed? (May 8, 2017). Available at SSRN: <https://ssrn.com/abstract=2965188> (“... the vast majority of corporate income [from public corporations] is not double-taxed in the United States”).

2. Assumes qualified dividends and ignores 3.8% Medicare surtax.

# Tax Rate Results: Retention versus Distribution\*

## C Corporation

**Distribute:** 36.8% total tax rate  
(because of double taxation)

**Retain:** 21% total tax rate

**Difference:** 15.8%

## Partnership

**Distribute:** 29.6% total tax rate

**Retain:** 29.6% total tax rate  
(assume §199A applies; otherwise 37%)

**Difference:** 0%

\*See Appendix A for calculations.

# Recent Examples:

## **Project Thunder:**

Conversion of an S corporation 3<sup>rd</sup> generation family-owned business.

→ S corp to C corp

## **Project Quarterhorse:**

Conversion of a life sciences company taxed as a partnership (to accommodate strategic investor).

→ Partnership to C corp

# Some Prominent Private Equity Converts (announced or completed)

APOLLO

 ARES

**Blackstone**

# Converting to a C Corporation

**DO NOT SIMPLY FOLLOW THE STATUTORY CONVERSION!**

E.g.,

K.S.A. 17-78-401 through 17-78-406 (for LLCs), or  
26 U.S. Code § 1362(d) (for S corporations).

**→ That's malpractice *per se*.**

# Conversions

- If the C corp decides to retain earnings, then consider our “old friends” –
  - Personal Holding Company Tax. IRC §541
  - Accumulated Earnings Tax. IRC §531
  - Other anti-abuse rules. IRC §269A
- No IRS guidance “any time soon.”
  - *Tax Notes, 6/8/2018*

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# New Section 199A: Qualified Business Income Deduction

- New deduction for 20 percent of qualified business income.\*
- Who can claim the deduction?
  - Individuals who own:
    - Sole proprietorships,
    - Partnerships,
    - S Corporations and
  - Some trusts and estates

\*Plus 20% of the aggregate amount of qualified real estate investment trust (REIT) dividends and qualified publicly traded partnership (PTP) income.

# New Section 199A (Cont'd.)

What is “qualified business income” (QBI)?

Any section 162 trade or business income with three exceptions:

1. A trade or business conducted by a **C corporation**.
2. For taxpayers with taxable income that exceeds the threshold amount, **specified service trades or businesses (SSTBs)**.
3. The trade or business of performing services as an **employee**.

# What Are the SSTB Thresholds (2018)?

- \$321,400 for a married couple filing a joint return
- \$160,725 for married filing separate
- \$160,700 for single and head of household

Rev. Proc. 2018-57, §3.27.

# SSTBs: Performing services in the following fields above a certain income threshold:

- Health or Law
  - Accounting or actuarial science,
  - Performing arts or athletics,
  - Consulting,
  - Financial services, investing and investment management,
  - Trading or dealing in certain assets
- Principal asset is reputation or skill of 1 or more employees  
→ **Certain trades or businesses where the principal asset is, basically, endorsements.**
  - *Not architects or engineers!*

# New Section 199A Regs Are Final

Good news and bad news.

## Good news:

- **Individuals can aggregate businesses and treat them as a single business, which can effectively increase the wage/capital limit on the deduction.**
- A qualified business can get up to 10% of its gross receipts from services.
- A qualified business can include a related rental activity.

## Bad news:

- Broaden the service-business category to include some non-service businesses that are incidental or related to a service business.
  - **Limits “crack and pack” strategies that try to create a qualified business by spinning off part of a service business.**
- Rebuttable presumption: former employee who continues to perform the same services for the employer is still an employee.
- Worker’s compensation is not qualified business income.

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# Section 1061

**What is carried interest?**



**Haters gonna hate.**

**One of “the most hated tax breaks in America.”**

*Bloomberg (June 3, 2019)*

# New Section 1061.

- What is carried interest? Term of art.
- What is a profits interest? IRS Rev. Procs. 93-27, 2001-43.
- What is a capital interest? IRS Rev. Procs. 93-27, 2001-43.
- What is an “applicable partnership interest”? IRC §1061(c).

# New Section 1061.

- Addresses “**applicable partnership interests**” held by owners in investment partnerships like Private Equity Groups (PEGs).
  - BUT sweeps more broadly than that.
  - Mostly does not address “plain vanilla” profits interests.
  - Could affect joint ventures.

# Long-term capital gain (LTKG) primer

In general,

- LTKG rate is 20% (maximum rate, ignoring the 3.8% Medicare surtax).
- STKG rate = ordinary income rate (37% maximum).

# LTKG holding period primer (in general)

- **More than one year** for most capital assets. IRC §1222(3).
- **More than two years** for profits interests (plus other conditions satisfied). IRS Rev. Procs. 93-27, 2001-43.
- **More than three years** for “applicable partnership interests.” IRC §1061.

# New §1061

- Result if §1061 applies
- Result if §1061 does not apply
- Does §1061 limit §1231 quasi-capital assets?

- 20% LTKG
- 37% STKG (ordinary inc. rates)
- Possibly, maybe, perhaps.

McGovern, Bruce A. and Brewer, Cassady V., Recent Developments in Federal Income Taxation: The Year 2018 (February 1, 2019). Tax Lawyer, Vol. 72, No. 4, 2019. Available at SSRN: <https://ssrn.com/abstract=3393963>

## Section 1061: Statute only; no cases or regs.

- No Cases or Treas. Regs. (As of 6/17/19)
- A few IRS notices, especially Notice 2018-18 (re: S corp loophole)
- 1061 regs listed as 30<sup>th</sup> on IRS “priority guidance plan.” (As of 4/15/19)

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# State and Local Taxes (SALT)

- United States Supreme Court eliminated old “physical presence” requirement for state sales tax nexus. *South Dakota v Wayfair, Inc.* (June 21, 2018)
- Result: Remote sellers who hit threshold sales in states may have sales tax collection, reporting, and remittance obligations
  - **Most states are \$100,000 or 200 retail transactions.**
- SALT typically does NOT have a statute of limitations.

# California: Seller Beware

- California looks to retroactively tax and penalize Fulfillment By Amazon (FBA) sellers
  - **Most FBA sellers don't even know they might have property stored in California warehouses.**
- State Treasurer Fiona Ma has asked Governor to issue executive order prohibiting California Dept. of Taxes and Fee Administration from assessing FBA sellers who don't have presence in California except Amazon distribution centers

# SALT in Other States

- Enacting marketplace facilitator laws that will require Amazon.com-type forums to collect on behalf of their sellers.
- Limited tax amnesty/voluntary compliance programs:
  - Previously delinquent sellers can avoid or minimize penalties for failure to file sales and use tax or corporate income tax returns.

## SALT in M&A: *Caveats Emptor and Venditor*

- SALT is much more important in the Due Diligence phase.
- Too much SALT may kill the deal.
- Project Lone Star example.
  - Sales tax insurance to the rescue!

# *Wayfair* Implications Beyond SALT

- Can a state tax trust income simply because that state has one trust beneficiary resident in that state?
- See *North Carolina Dep't of Rev. v. Kimberley Rice Kaestner 1992 Family Trust* (“*Kaestner Trust*”), No. 18-457 (U.S.) (state’s efforts to tax trust income due to North Carolina beneficiary). Decision pending as of June 20, 2019.
- **June 21, 2019 update: U.S. Supreme Court decides *Kaestner Trust* case (9-0). Holding: The presence of in-state beneficiaries alone does not empower a State to tax trust income that has not been distributed to the beneficiaries where the beneficiaries have no right to demand that income and are uncertain to receive it.**

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# Qualified Opportunity Zone Benefits

1. Capital Gain Deferral.
2. Partial Capital Gain Forgiveness.
3. Tax Basis Increase.

# Qualified Opportunity Zone Benefits

- Deferral of 100% of Capital Gain on sale of property (“Original Property”) until the earlier of:
  - Sale of QOF investment, or
  - December 31, 2026
- Partial Original Gain Forgiveness depending on length of investment in Qualified Opportunity Fund (QOF)
  - 10% if investment in QOF held for at least 5 years
  - 15% if investment in QOF held for at least 7 years



# Qualified OZ Benefits (Cont.'d)

- Basis increase in QOF investment to shield additional gain on investment in Qualified Opportunity Zone Property (QOZP)
  - Increase in tax basis of QOF investment to FMV if investment in QOF held for at least 10 years
  - Ability to benefit from basis increase for all qualified investments made prior to June 30, 2027
  - Investors permitted to hold investment until December 31, 2047

# Potential Investment Types in Opportunity Zones

- Construction & Development of Commercial Real Estate
- Development & Renovation of Existing Property in Opportunity Zone
- Creation of a new business in a Opportunity Zone
- Expansion of existing business in a Opportunity Zone

# Combining OZ Investments with Other Tax Incentives

- Low-Income Housing Tax Credit
- Historic Rehabilitation Tax Credit
- New Markets Tax Credit
- Renewable Energy Tax Credits
- State Tax Credit Programs (where applicable)
- Other state and federal loan and grant programs

# Opportunity Zone Investment Example

See Appendix B

# Where Are the Opportunity Zones?

- Opportunity Zones can be located at <https://eig.org/news/opportunity-zones-map-comes-focus>

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# Mergers and Acquisitions

1. Deal activity and valuations **down**.
2. Diligence: longer, more detailed.
3. Insurance Policies: RWI, sales tax, etc.
4. SALT
5. OZ



"We're buying the company, the brand, the building ...  
but mostly we're buying the golden eggs."

# Mergers and Acquisitions

1. Deal activity and valuations **down**. U.S. Core Middle Market deals (\$25mm to \$249.9mm) are down (compared to 2018) from (-9.7%) to (-16.5%).

→ Both volume and deal size are down.

Source: FactSet Flashwire US Monthly (May 2019) accessed 6/17/19



# Choice of Entity: Simple Math

## Distributed Income versus Retained Income

# Distributed Income

## C Corporation

\$100 income  
(21) federal inc. taxes  
79 balance  
**(15.8) 20% dividend tax rate\***  
63.2 balance  
36.8% total tax rate

\*Assumes tax paying stockholder and qualified dividends; ignores 3.8% Medicare surtax.

## Partnership

\$100 income  
0 federal income taxes  
\$100 allocated to partners  
(29.6) federal taxes\*  
70.4 balance  
29.6% total tax rate.

\*Assumes §199A applies.

# Retained Income

## C Corporation

\$100 income

(21) federal inc. taxes

79 balance

**(0) 20% dividend tax rate**

79 balance

21% total tax rate

## Partnership

\$100 income

0 federal income taxes

\$100 allocated to partners

(29.6) federal taxes\*

70.4 balance

29.6% total tax rate.

\*Assumes §199A applies.

# Opportunity Zone Investment Example

- January 2, 2018
  - Taxpayer enters into a sale of property that results in \$1M of capital gain
    - June 30, 2018 (which is within the 180 day requirement), the Taxpayer contributes cash equal to the entire \$1M of capital gain to obtain an interest in the Qualified Opportunity Fund
    - Qualified Opportunity Fund invests the \$1M in a Qualified Opportunity Zone Property (stock, partnership interest, business property)
      - REMINDER: Taxpayer is deemed to have a \$0 basis in its Qualified Opportunity Fund investment to retain taxability.
      - NOTE: The cash used to make Qualified Opportunity Fund investment does not need to be traceable to original gain transaction.

# Opportunity Zone Investment Example (Cont'd)

- June 30, 2023
  - After 5 years, the Taxpayer's basis in the Qualified Opportunity Fund investment is increased from \$0 to \$100k
- June 30, 2025
  - After 7 years, Taxpayer's basis in the Qualified Opportunity Fund investment is increased a further \$50,000 (from \$100k to \$150k)
- December 31, 2026 – NOTE: Statutory deadline for all gains to be triggered (required taxable event)
  - \$850k of the \$1M of deferred capital gains are taxed and the basis in Qualified Opportunity Fund investment increases to \$1M
  - It is hoped that this deadline will be amended to be a rolling 7 year deadline determined by the year of investment
- June 30, 2028
  - After 10 years, Taxpayer sells its investment for \$2M
    - Taxpayer's basis in the Qualified Opportunity Fund investment is deemed by statute to be equal to current market value after 10 years
    - The effect is no tax on unrealized appreciation of the original investment in the Qualified Opportunity Fund (avoids gain on the new \$1,000,000 created by the unrealized appreciation of the original investment)
  - After 25 years,<sup>10</sup> Taxpayer sells its investment for \$5M
    - Taxpayer's basis in the Qualified Opportunity Fund investment is deemed by statute to be equal to current market value at time of sale
    - The effect is no tax on unrealized appreciation of the original investment in the Qualified Opportunity Fund (avoids gain on the \$4,000,000 created by the unrealized appreciation of the original investment).

<sup>10</sup>The result is the same if the investment is sold on or before December 31, 2047

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